85350-3A

The Manufacturers Hanover
Economic Report

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Chief Economist

JUNE 1986

Business Conditions Update

Change is in the wind. After two years of sluggish growth, the U.S. economy seems to be on the verge of a pickup. The gross national product adjusted for inflation could very well rise at a four percent annual rate in the next twelve months—about twice as fast as the two percent pace it posted during the past two years. Because of this, among other factors, there is a change in the outlook for inflation. Deflation, or falling prices, is now a thing of the past and in its place have reappeared rising prices, or inflation. The financial markets have already reacted to these changes. In anticipation of an improving economy accompanied by rising prices, along with a change in Federal Reserve monetary policy, interest rates have stopped falling and are up from their lows reached earlier this year.

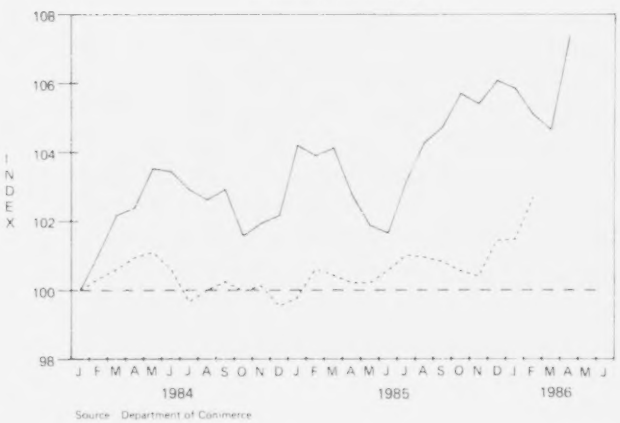
Faster Growth Is On Tap ...

Some of these changes will be evident when the second quarter's data are released in July. Although the real GNP's growth rate will probably be less than that of the first quarter, in many respects, the second quarter should look a lot better than the first (see table inside). For one thing, less of the rise in GNP will reflect an increase in business inventories. Indeed, it would appear that there was a sharp cutback in the rate of business inventory accumulation in the second quarter compared with the first, when there was a big increase. This was one of the main reasons why the top-line GNP figure grew more slowly in the second quarter than it did in the first. However, beneath the surface, things are somewhat brighter, since sales to final consumers appear to have picked up, in contrast to the decline posted in the first quarter. Finally, the decline in our trade deficit—although slight—nonetheless suggests that more of what was purchased by consumers, business and governments was made in the United States, rather than overseas.

I noted back in the February Economic Report that there were a number of developments which had already occurred that made us hopeful. Let me repeat these briefly along with their implications:

- The foreign exchange value of the dollar has fallen by nearly 30 percent since the end of February, 1985. This has stemmed the rise in our trade deficit—a major drag on economic growth.

LEADING ECONOMIC INDICATORS:
FINANCIAL (LINE) VS. NONFINANCIAL (DOT) COMPONENTS
(JANUARY 1984=100)



Source: Department of Commerce

- Growth in the money supply in 1985 was the fastest for any year in postwar history and appears to have accelerated during the first half of 1986. This caused a sharp decline in interest rates, making it easier for people and for businesses to borrow in order to make big-ticket purchases.
- Employment has grown much faster than usual in this business expansion and is now at a record level in terms of the number of people at work, and close

NO REPORTS IN SUMMER

The Economic Report will not be published during July and August. The next issue will appear in September.

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to a record when compared with the over-sixteen population. This has enhanced buying power and confidence.

- The stock market has jumped by nearly 40 percent since last September and is more than twice the level touched back in August 1982. This has added more than $1 trillion to the value of stocks, an amount equal to 28 percent of the gross national product or nearly $5,000 for every man, woman and child in the United States. This has bolstered the buying power of investors in particular, and confidence among the populace at large.
- Oil prices in spot markets have plunged precipitiously since last autumn, falling at one point by as much as two-thirds. This has also added to buying power and caused inflation to be stopped dead in its tracks.

Notwithstanding these facts and their positive implications, some people remain skeptical about the near-term prospects for the U.S. economy. To be sure, few would say that we are on the verge of, or are already in, a recession. However, the plethora of mixed statistics that have come out in recent months has made some skeptical of the imminence of an economic rebound. It is easy to be distracted by the negative numbers when one is looking for a positive outcome. Let us not forget that there are a few positive statistics out there—some of which are visible and some of which are obscured.

... Spurred By Housing and Consumers

The most visible is housing. Thanks to rising personal incomes, relatively stable home prices and steep declines in mortgage interest rates, housing is on a roll. The number of new single-family homes sold in the March-April period rose to a record 878,000 units at a seasonally adjusted annual rate, surpassing the previous two-month record set back in May-June 1978. Although new-home construction shot up 12 percent in the first quarter compared with the fourth, it was not enough to keep up with the sizzling selling pace. The net result is that the inventory of unsold new homes now measures only 4.7 months at recent selling rates—the lowest level in almost 15 years. With the number of households planning to buy a home the highest since 1978, many are turning to resales. Existing single-family home sales topped 3.5 million units at a seasonally adjusted annual rate at last count—the highest reading since late 1979.

As housing goes so go many other industries. The ripples from the housing boom have benefited manufacturers of such construction materials as lumber, gypsum, roofing and glass. Homebuilding also aids those manufacturers who produce finished products including major appliances, cabinets, and bathroom fixtures, to name a few. The Association of Home Appliance Manufacturers estimates that in April, 3.7 million major household appliances were shipped, establishing a new record for the month. And the Conference Board reports that the number of consumers planning to buy a new major appliance in the next half-year has been running at a strong pace for several months.

Not surprisingly, consumer spending in general continues to grow—although you wouldn't know it from a glance at the latest retail sales figures. Retail sales in May fell 0.1 percent following a rise of only four-tenths of one percent in April and a drop of four-tenths of one percent in March. However, there is more to this than meets the eye. For one thing, there was a 2.8 percent jump in sales of furniture and home furnishings—an important category, since it consists of big-ticket items. For another, the overall sales figures are not adjusted for price changes.

In real terms, retail sales are doing better than the nominal, or dollar figures would suggest. This is because prices of most items at retail are either stable or falling. Calculations by this Bank indicate that real retail sales in April and May averaged 1.6 percent higher than in the first quarter. Even if June's sales are no higher than this two-month average, the annual rate of increase for the second quarter will be 6½ percent.

June, 1986
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual						Projected >					
	1985				YEAR 1985		1986				YEAR 1986	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross National Product	3917.5	3960.6	4016.9	4059.3	3988.6	5.7	4115.7	4159.8	4225.2	4290.6	4197.8	5.2
GNP: $82	3547.8	3557.4	3584.1	3590.8	3570.0	2.2	3616.9	3635.0	3670.9	3705.2	3657.0	2.4
% Change, Annual Rates	3.7	1.1	3.0	0.7	2.2		2.9	2.0	4.0	3.8	2.4	
Consumption	2525.0	2563.3	2606.1	2634.8	2682.3	6.6	2668.2	2702.3	2740.2	2760.3	2717.8	5.2
Durables	351.5	356.5	376.0	362.0	361.5	9.2	363.1	373.2	381.9	389.6	376.9	4.3
Non-Durables	895.7	910.2	914.5	928.3	912.2	4.6	935.6	931.1	941.0	948.2	939.0	2.9
Services	1277.8	1296.6	1315.6	1344.6	1308.6	7.3	1369.5	1397.9	1417.3	1422.6	1401.8	7.1
Investment	657.6	672.8	666.1	680.7	669.3	−0.7	717.2	705.3	719.7	735.9	719.8	7.5
Non-Residential	459.6	474.2	478.5	492.5	476.2	11.3	479.1	480.6	485.2	492.3	484.3	1.7
Producers Durable Equipment	293.5	304.5	308.1	318.0	306.0	9.2	309.9	311.2	316.6	325.2	315.7	3.2
Structures	166.1	169.7	170.4	174.5	170.2	15.3	169.1	169.4	168.7	167.1	168.6	−0.9
Residential	179.4	183.1	187.4	192.5	185.6	3.6	198.2	210.6	220.2	227.3	214.1	15.3
Inventory Changes	18.5	15.5	0.2	−4.3	7.5		39.9	14.2	14.2	17.3	21.4	
Net Exports	−42.3	−70.3	−87.8	−113.4	−78.5		−105.8	−89.0	−90.8	−90.7	−94.1	
Government Purchases	777.2	794.8	832.5	857.2	815.4	10.7	836.2	847.2	856.1	859.4	849.7	4.2
Federal Defense	249.5	256.0	269.9	272.1	261.9	10.5	268.0	270.4	272.5	274.1	271.2	3.6
Federal Civilian	84.9	81.7	95.0	112.6	93.5	23.1	89.1	90.6	90.2	87.6	89.4	−4.4
State & Local	442.8	457.1	467.7	472.5	460.0	8.5	479.0	486.2	493.3	497.7	489.1	6.3
Final Sales: $82	3532.0	3542.3	3585.8	3597.1	3564.3	3.9	3581.6	3621.4	3657.2	3688.7	3637.8	2.1
% Change, Annual Rates	6.2	1.2	5.0	1.3	3.9		−1.7	4.2	4.0	3.5	2.1	
Domestic Demand: $82	3619.6	3658.5	3703.9	3731.6	3678.4	2.8	3747.2	3764.0	3796.6	3819.4	3781.8	2.8
% Change, Annual Rates	0.4	4.4	5.1	3.0	2.8		1.7	1.8	3.5	2.4	2.8	
GNP Price Index (1982 = 100)	110.4	111.3	112.1	113.0	111.7	3.3	113.8	114.4	115.1	115.8	114.8	2.8
% Change, Annual Rates	3.0	3.3	2.9	3.3	3.3		2.9	2.1	2.5	2.6	2.8	
Consumer Price Index (1967 = 100)	317.9	321.0	323.1	326.5	322.1	3.5	327.7	326.6	329.1	332.0	328.8	2.1
% Change, Annual Rates	3.2	4.0	2.6	4.3	3.5		1.4	−1.3	3.1	3.6	2.1	
Total Personal Income	3240.9	3280.1	3298.5	3354.3	3293.5	5.8	3397.5	3442.9	3487.5	3493.7	3455.4	4.9
Disposable Personal Income	2739.2	2817.7	2800.2	2845.9	2800.8	4.9	2893.4	2934.8	2967.0	2972.2	2941.8	5.0
Savings Rate	4.8	5.9	3.7	4.0	4.6		4.4	4.6	4.1	3.2	4.1	
Unemployment Rate	7.3	7.3	7.2	7.0	7.2		7.1	7.2	6.9	6.8	7.0	
Indus. Production (1977 = 100)	123.8	124.2	124.8	125.4	124.5	2.3	125.6	124.7	125.9	127.8	126.0	1.2
Housing Starts (000)	1761.7	1742.7	1687.7	1773.3	1741.3	−1.2	1998.3	1975.7	2013.3	2105.2	2023.1	16.2
Domestic Auto Sales (000)	8454.7	8239.0	9440.3	6996.3	8282.6	4.2	7884.3	8117.0	7861.0	7905.1	7941.8	−4.1
Corporate Pre-Tax Profits	220.0	218.7	228.6	233.8	225.3	−5.2	216.6	228.9	240.8	243.7	232.5	3.2
− Taxes	83.4	82.3	87.4	87.1	85.0		79.7	80.1	89.1	92.6	85.4	
Net Profits	136.6	136.4	141.1	146.7	140.2	−2.6	137.0	148.8	151.7	151.1	147.1	5.0
− Dividend Payments	82.0	83.1	83.9	85.0	83.5	6.9	87.6	99.7	101.6	101.2	97.5	14.7
Undistributed Profits	54.6	53.3	57.3	61.7	57.7	−13.9	49.4	49.1	50.1	49.9	49.6	−12.5
+ Depreciation	325.4	334.0	346.8	354.2	340.1		356.2	360.3	364.7	368.4	362.4	
− Inventory Profits	−0.7	−2.2	−4.7	10.1	0.6		−18.0	−27.2	−6.6	10.0	−10.4	
Net Cash Flow	380.7	389.5	408.8	405.8	396.2	10.6	423.6	436.6	421.4	408.3	422.5	6.6

In the first quarter, real retail sales grew at an annual rate of 4¾ percent compared with last year's fourth quarter. Thus consumer spending, the mainstay of the economy, is still rising, and seems to be providing the underpinnings for a return to growth in real final sales in the second quarter, as well as later on this year, since employment continues to expand.

Turning to foreign trade, it would appear that the trade deficit has hit a peak and is now declining. Both in the gross national product accounts as well as in other measures, the deficit in our balance of trade is shrinking. The drop in the trade deficit in the first quarter compared with the fourth helped boost the first quarter's GNP: Domestic demand grew more slowly in the first quarter than it did in the fourth. Since last September, exports adjusted for higher prices have risen by more than five percent or an annual rate of nearly nine percent. By contrast, real imports have declined by 4½ percent, or an annual rate of nearly eight percent.

Looking ahead, the government's measure of statistics that tend to change direction ahead of the economy is climbing noticeably. The Commerce Department's index of leading economic indicators has jumped by an average of more than one percent a month in the last three months—with the April increase the best in 2½ years. Even more significant—for the first time in two years, those components which measure the production sector are rising, in contrast to earlier months, when the bulk of the increases was centered mainly among those indicators that track the financial sector (see chart on page 1).

Inflation Is Back ...

As for the price situation, it would appear that the days of deflation have ended. The April Economic Report warned that earlier declines in prices at the consumer and at the producer level were due mainly to falling oil prices. The end of falling oil prices allowed the producer price index in May to pop up by 0.6 percent or a 7.8 percent compounded annual rate. For its part, the consumer price index last month rose after three consecutive monthly declines.

To assess the outlook for inflation, one might want to imagine an inflation balance sheet. On one side are factors that have brought inflation down while on the other are factors which tend to push prices up. Six years ago, in the spring of 1980, consumer prices were rising at a rate of 14 percent, while producer prices were up at a 20 percent clip. Since then, four factors have intervened to turn spiraling inflation into deflation six years later. The first was tight money, instituted by newly-appointed Fed Chairman Paul A. Volcker starting in late 1979. But that ended in the middle of 1982 and has since been replaced by easy money which may

eventually fuel inflation. A recession ensued in first-half 1980 followed by another one starting in August 1981 which didn't end until November 1982. This has obviously ended since we are now in the fourth year of a business expansion. The dollar climbed by 90 percent between July 1980 and February 1985, exerting a downward pull on the price level, but since then the dollar has plunged. Finally, oil prices declined starting last October, but they bottomed out in early April and have since risen a few dollars a barrel.

Looking at those factors pushing prices higher, besides easier money, the weaker dollar, and rising oil prices, we have tightening labor markets as a result of the surge in employment and a shortage of workers with certain skills in some parts of the country. Also, the service component of the consumer price index, which was rising at a five percent clip throughout the period of slowing inflation, is now rising at a seven percent annual rate—and services comprise more than half of the CPI.

While inflation is back, it is not likely to accelerate into the danger zone anytime soon. The best guess is for prices to rise at between a three and four percent annual rate over the balance of this year at the consumer level, and around two percent or so at the producer level. This will not be enough to cause the Federal Reserve to think about tightening money, and, hopefully, will not preclude further declines in rates.

... But Not Enough to Boost Interest Rates

This brings me to the third change and that is in the direction of interest rates. Interest rates in long- and short-term markets had tumbled, with long-term rates falling some three percentage points in less than one year's time while short-term rates dropped by a little over two points. However, a bottom was reached in early spring; since then most interest rates have climbed. Part of this change in direction is due to expectations of faster growth. A pickup in business increases the demand for funds. At the same time a return to inflation might justify higher interest rates. But part of the backup in rates may also trace to a change in Federal Reserve policy.

The Fed no longer seems to be leading the way toward lower interest rates. Rather, it appears to have adopted a neutral policy for the time being, neither pushing rates lower nor encouraging them to rise. However, this change, unlike the previous two, might be temporary. Indeed, if it isn't, then one of the other changes—faster growth—may not occur. This is because, for all their declines, interest rates adjusted for inflation are still high, compared with historical experience. And most economists—not to mention virtually all businessmen—would agree that high real interest rates are hazardous to the economy's health.

Considering the problems still extant in manufacturing, among farmers and developing countries, plus the low rate of inflation and the high rate of unemployment, it is not unreasonable to hope that the Federal Reserve will resume pushing interest rates lower until they reach the right level to rekindle economic growth. A reduction in Washington's budget deficit would help, too. H

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SEPTEMBER 1986

Why Our Trade Gap Persists

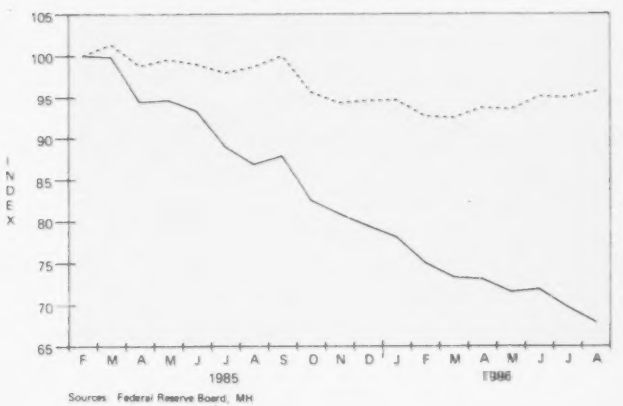
A year and a half has now gone by since the dollar began its monumental slide in the foreign exchange markets. Although it portended higher prices for consumers, this decline was welcomed because it meant that the goods-producing sector would eventually become more competitive with foreign-made products, here and abroad. Washington did more than welcome the dollar's slide—it aided and abetted it. The net result is what appears to be a greater than 30 percent drop in the value of the dollar on a trade-weighted basis.

As this decline got underway, businessmen began gearing up for increased demand while economists both in and out of Washington raised their forecasts for the real gross national product. Both groups based their optimism on the belief that a decline of this magnitude in the foreign exchange value of the dollar would soon divert spending away from foreign-made products, and towards domestically-produced items. This would mean that even if growth in consumption were to slow, an anticipated narrowing of the trade deficit would lead to faster growth in domestic output.

Of course, such a shift was not expected to occur overnight. Thus forecasts of better growth focused on 1986, rather than in the months immediately following the start of the dollar's plunge. As the trade deficit failed to narrow, economists pointed to such factors as the J curve effect (Economic Report—January 1986), suggesting that it takes time before the trade gap of a country with a declining currency stops expanding and begins to shrink. As the deficit continued to widen, other explanations were offered, such as the belief that exporters in some countries were not raising their prices by as much as their currencies rose against the dollar in order to retain market share in the United States and elsewhere.

The next issue will appear in November.

CHART I
TRADE-WEIGHTED DOLLAR EXCHANGE RATE:
FEDERAL RESERVE (LINE) VS. MHT (DOT)
(FEBRUARY 1985=100)



Sources: Federal Reserve Board, MH

These explanations are probably accurate as far as they go. However, they overlook an important aspect of the dollar's behavior. This is the fact that it has not fallen uniformly against all currencies. Rather, the dollar has dropped sharply against a few, held steady against others—and actually risen against some. The informed reader would question the significance of this revelation, since most measures of the trade-weighted dollar show a substantial decline in its value since February 1985. We would respond by saying that of all the explanations offered for the failure of the trade gap to narrow in response to the lower-valued dollar, the fact that the dollar has not declined uniformly may well turn out to be one of the most important.

The Trade-Weighted Dollar...

It would appear that a new calculation of the trade-weighted dollar is called for. This is because the Federal Reserve's index, for one, does not seem to be painting a realistic picture of what has happened to the dollar with respect to the currencies of our most important trading partners. For one thing, the currencies in the Fed's index belong to those countries whose total worldwide trade—not just trade with the United States—was the largest in the years 1972 to 1976. The weight of each foreign currency in the index is the ratio

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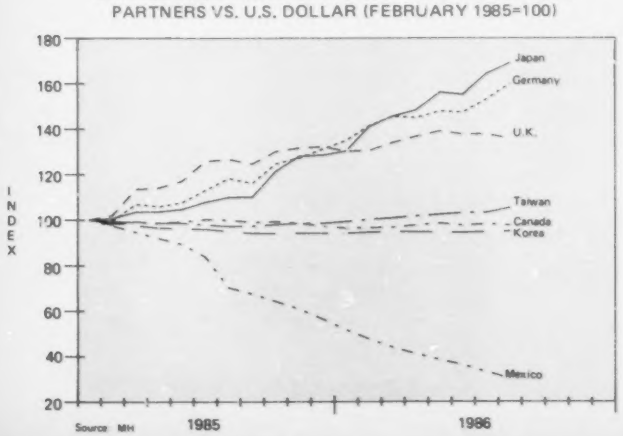
of that country's worldwide exports plus imports to the worldwide exports plus imports of the ten largest trading countries during those years. Thus the German mark has the largest weight in the Fed's index.

However, in order to measure the potential impact of the dollar's depreciation in foreign exchange markets on our trade performance, a trade-weighted index should include the currencies of those countries whose trade is currently most important to the United States. This is especially true nowadays, since the countries whose currencies have increased against the dollar over the past 18 months are chiefly the industrial countries of Europe and Japan. The dollar has declined by an average of 34½ percent against the currencies of these countries—but they only account for 38½ percent of our trade (see table). To get a truer picture of the trade-weighted value of the dollar, it is necessary to take into account—and give proper weight to—the currencies of a number of other countries. For of the nearly $110 billion deterioration in the U.S. trade deficit between 1981 and 1985, around one-half was with Canada, Latin America, and the newly industrializing countries (NICs) of Southeast Asia.

Constructing an index based on the currencies of our 17 largest trading partners in 1985 weighted by their share of U.S. trade (exports plus imports), reveals that the dollar has actually declined by little more than four percent from its February 1985 peak (Chart I). What is more, as the table reveals, if you take the currencies of our top seven trading partners alone—which, by the way, account for 61 percent of our trade and 75 percent of our deficit—you will find that the dollar has *risen* by an average of over 11 percent since February 1985 (Chart II). And if you focus on just six of our 17 major trading partners (Canada, Mexico, Taiwan, Korea, Hong Kong and Brazil) which account for 35 percent of both our trade and of our deficit, you will see, astoundingly, that the dollar has jumped by an average of 71 percent since February 1985!

CHART II
CHANGE IN CURRENCIES OF TOP SEVEN U.S. TRADING PARTNERS VS. U.S. DOLLAR (FEBRUARY 1985=100)



In comparing the Federal Reserve's trade-weighted dollar with the Manufacturers Hanover trade-weighted dollar, several observations stand out:

- The Fed's index is based on trading patterns of the mid-1970s, whereas ours is based on last year's.
- The ten countries included in the Fed's index accounted for little more than half (57.8 percent) of total U.S. trade in 1985, whereas this country's 17 largest trading partners whose currencies are included in our index, accounted for nearly four-fifths (78.3 percent) of total U.S. trade last year.
- The U.S. dollar has depreciated against every currency in the Fed's index except the Canadian dollar, against which the U.S. currency has appreciated slightly. However, the U.S. dollar has risen against the currencies of six of our 17 largest trading partners while remaining unchanged against two others.
- While the mark is the most heavily weighted currency in the Fed's index, Germany's share of U.S. trade in 1985 was only 5.3 percent, about the same as the 5.2 percent figure in 1975. Germany in 1985 was only our fourth largest trading partner so an index that gives the mark the heaviest weight is not a true representation of U.S. trade patterns.
- The Fed's index completely excludes the newly industrializing countries (NICs) of Southeast Asia—Taiwan, South Korea, Hong Kong and Singapore. The omission of these countries is striking, since this area represents one of the fastest growing components of U.S. trade in recent years. Our trade with these countries has increased from $11 billion in 1975 to an annual rate of nearly $65 billion so far this year, while our trade deficit with these countries has soared from less than $500 million in 1975 to an annual rate of nearly $29 billion.
- Another area of the world where U.S. trade patterns have changed dramatically since the Federal Reserve's index was created in the mid-1970s is Latin America. Of this country's 17 largest trading partners whose currencies are included in the Manufacturers Hanover trade-weighted dollar index, three are from Latin America: Mexico (our fourth largest trading partner this year), Brazil (our 12th largest) and Venezuela (our 14th largest). As the table indicates, we are running trade deficits with all three. None of these countries' currencies is included in the Fed's index.
- The Fed's index includes the currencies of Sweden and Switzerland, which are not in the Manufacturers Hanover index. However, together, these two countries accounted for only two percent of U.S. trade in 1985.

COUNTRIES INCLUDED IN MANUFACTURERS HANOVER'S TRADE-WEIGHTED DOLLAR INDEX

Ranked by Importance to U.S. Total Trade (Exports Plus Imports)

U.S. Deficits (−) Surpluses (+)

Country	January-July 1986 U.S. Total Trade ($ bil.)	Percent of U.S. Total Trade	Cumulative Percent of U.S. Total Trade	January-July 1986 U.S. Trade Balance ($ bil.)	Percent of U.S. Total Deficit	Percentage Change in the U.S. Dollar from Feb '85 to Aug '86 Against the Currencies of:
Canada[1]	66.7	18.9	18.9	−14.1	13.8	2.6
Japan[1]	66.2	18.7	37.6	−34.2	33.5	−40.8
Germany[1]	21.0	5.9	43.5	−9.4	9.2	−37.4
Mexico	18.0	5.1	48.6	−3.2	3.1	231.7
U.K.[1]	16.1	4.5	53.1	−2.8	2.7	−26.2
Taiwan	14.7	4.2	57.3	−8.7	8.5	−4.9
South Korea	11.2	3.2	60.5	−3.9	3.8	5.6
France[1]	10.7	3.0	63.5	−2.3	2.3	−33.3
Italy[1]	9.6	2.7	66.2	−3.9	3.8	−30.1
Netherlands[1]	7.1	2.0	68.2	+1.8	−1.8	−37.7
Hong Kong	6.8	1.9	70.1	−3.4	3.3	0.0
Brazil	6.4	1.8	71.9	−2.6	2.5	267.7
Belgium-Luxembourg[1]	5.7	1.6	73.5	+0.5	−0.5	−35.5
Venezuela	5.2	1.5	75.0	−1.5	1.5	0.0
China	4.9	1.4	76.4	−0.9	0.9	31.1
Australia	4.8	1.4	77.8	+1.5	−1.5	21.0
Singapore	4.7	1.3	79.1	−0.8	0.8	−4.3
Others[2]	73.8	20.9	100.0	−14.1	13.8	—
Total	353.6	100.0	—	−102.0	100.0	—

Sources: IMF; Dept. of Commerce; MH

[1]Contained in the Federal Reserve's trade-weighted dollar index, along with Sweden and Switzerland.
[2]Not included in MH trade-weighted index.

...Has Not Declined As Much...

As you can see from the table, Canada is now our largest trading partner, acounting for nearly 19 percent of U.S. trade so far this year. In an almost $120 billion annual two-way trade, it is the world's largest bilateral relationship. Canada is our top export market, taking over 22 percent of our foreign sales in 1985. We sell more to Canada than to the entire European common market, more to the province of Ontario than to Japan. However, the U.S. trade deficit with Canada has grown rapidly over the past decade, widening from $1 billion in 1975, to $7.2 billion in 1981, to $22 billion in 1985, second only to Japan. So far this year, the deficit is running at more than a $24 billion annual rate. Thus it is inaccurate to assign Canada fifth place, as the Fed's index does.

While declining against the currencies of the other industrialized countries, the U.S. dollar has advanced by nearly three percent against its Canadian counterpart since February 1985, bringing the total U.S. dollar appreciation against the Canadian dollar since July 1980 to 20½ percent. In view of this exchange rate movement, the reason for the rapid growth of our trade deficit with Canada becomes obvious. U.S. companies have found it increasingly difficult to challenge their Canadian competitors on the basis of price.

Turning to another area, a close examination will reveal the growing importance of the newly-industrializing countries of the Pacific Basin to U.S. trade. As you can see from the table, two of our five largest deficit positions are with NICs from this part of the world—Taiwan and Korea—while with Hong Kong we posted our seventh largest trading deficit. This contrasts sharply with the trade situation in 1975, when the U.S. ran surpluses with Korea and Singapore, and only modest deficits with Taiwan and Hong Kong.

The currencies of these NICs are closely linked to the dollar, so the decline in the U.S. currency against the currencies of the industrial countries has done very little to improve our trade competitiveness with them. Since 1979, the Taiwan dollar has been tied to a basket of currencies whose largest weight is the U.S. dollar. The U.S. dollar has depreciated by less than five percent against the Taiwan dollar since February 1985. On the other hand, the South Korean won is also linked to the dollar—but since February 1985 the dollar has actually risen by 5½ percent. The Singapore dollar, likewise, is tied to the U.S. dollar, but it has been allowed to rise against its U.S. counterpart since February 1985. As for Hong Kong, in October 1983 the government adopted a fixed exchange rate policy, pegging the Hong Kong dollar to the U.S. dollar at 7.8/$. Thus there has been no change in the relationship of the U.S. dollar to the Hong Kong dollar since February 1985.

These Southeast Asian NICs have managed to score major trade gains as a result of tying their currencies to the U.S. dollar. And of course, since their currencies have also depreciated against the Japanese yen, these NICs have made major inroads into Japan's export markets both in the U.S. and elsewhere. Besides their exchange rate policies, low labor costs have given these NICs a competitive edge over their U.S. counterparts. In addition, because of rapid developments in technology, these NICs have diversified from low-priced consumer goods to more sophisticated manufactured goods. Thus as the costly yen squeezes Japanese goods out of the U.S. market, the NICs are moving in. It could well be that once our trade picture with Japan finally improves, it will be offset by worsening deficits with the newly industrializing countries of Southeast Asia, giving little relief to our beleaguered manufacturing sector.

Until the developing country debt crisis made the front pages, Latin America was a major growth market for U.S. goods. Now it's no longer the case. Prior to 1982, economic growth was the chief priority of most Latin American countries. Policies implemented to achieve this objective had an extremely favorable impact on the U.S. trade balance during the 1970s and the early part

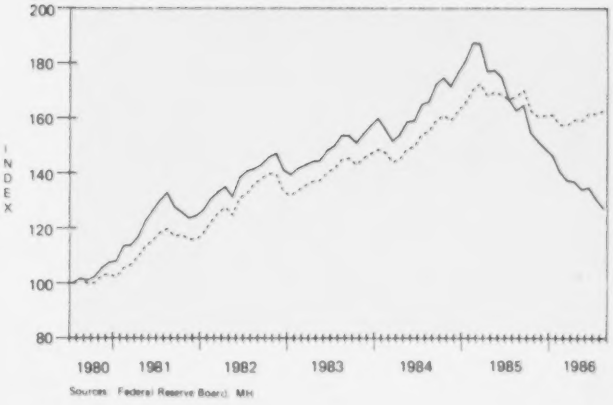
of this decade. Latin American development plans led to heavy imports of U.S.-produced capital goods, while rapid economic growth in Latin America attracted an influx of consumer goods as well. As a result, the U.S. posted a number of trade surpluses with Latin America, culminating in a $1.3 billion trade surplus in 1981.

All this changed in the next year. The debt crisis of 1982 forced Latin American countries to redefine their priorities and readjust their policies. Earning foreign exchange to meet debt payments became the chief priority of most Latin American nations. Economic policies to achieve this goal had major effects on the U.S.-Latin American trade balance. Export promotion programs and more realistic exchange rate policies caused exports from Latin America to the United States to surge by over 20 percent between 1981 and 1985. At the same time, import restrictions and a recession in Latin America led to a 26 percent plunge in exports from the United States, producing a trade deficit with Latin America of more than $18 billion by last year.

...As Is Generally Believed

It seems pretty clear, to us, at least, that in order to properly analyze and evaluate our trade position worldwide, thus the outlook for the U.S. economy, it is necessary to look at a broader, more up-to-date index of the trade-weighted dollar than the one provided by the Federal Reserve. When you do, you can see perhaps the chief reason why our trade deficit has remained large, and why the industrial sector of the

CHART III
TRADE-WEIGHTED DOLLAR EXCHANGE RATE:
FEDERAL RESERVE (LINE) VS. MHT (DOT)
(JULY 1980=100)



Sources: Federal Reserve Board; MH

U.S. economy remains in low gear. As Chart III shows, the Fed's trade-weighted dollar may be back down to 1981 levels—but ours is still as strong as it was two years ago, and remains 63 percent above July 1980. Therefore, it would seem that for the U.S. trade gap to narrow significantly, the dollar will not only have to fall further against those currencies where it has already declined—it must also drop against at least some of those currencies where until now it has either been stable or still rising. H

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